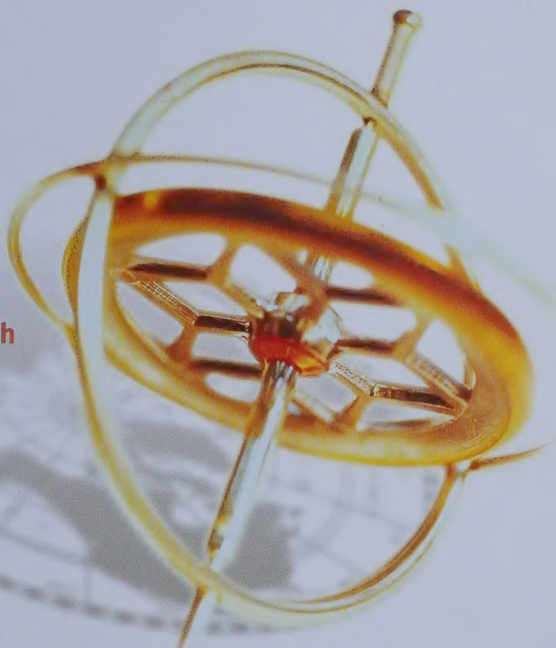
equatorial energy inc.



balanced growth

1998 annual report

Corporate Profile

Equatorial Energy Inc. is a Calgary-based independent Corporation engaged in the acquisition, exploration, and development of petroleum and natural gas interests in western Canada and Indonesia.

The Corporation's Indonesian activities are managed by Equatorial Energy (International) Inc., which owns two Indonesian subsidiaries: Pilona Petro Tanjung Lontar Ltd. and Energy Process Services Limited (EPS). EPS owns 80 per cent of the issued and outstanding capital stock of Genindo EPS Petroleum Ltd.

The Corporation has grown rapidly in its first three years of operation, and is now positioned to increase production from its domestic and international properties.

balanced growth fo

Milestones for 1998

- Negotiated property purchase for $72 million in western Canada, which included 16.4 mm boe reserves, 5,000 boe/d production and more than 400,000 net acres of undeveloped land (purchase closed February 1999).
- Acquired 80 per cent working interest in the Sembakung oil field in northeast Kalimantan, Indonesia with reserves of 36 million barrels recoverable light oil and current production of 3,000 barrels of oil per day.
- Commenced drilling program in the Tanjung Lontar field in South Sumatra, Indonesia, resulting in eight oil wells and one dry hole.

Financial Highlights

For the year ended December 31	1998	1997	1996
Revenue, net of Government take	$ 2,591,141	$ –	$ –
Net loss	$ (24,364,969)	$ (1,053,371)	$ (521,660)
Net loss per share	$ (0.82)	$ (0.07)	$ (0.07)
Funds used in operations	$ 2,800,342	$ 1,026,593	$ 518,097
Funds used in operations per share	$ 0.09	$ 0.07	$ 0.07
Working capital	$ 369,742	$ 8,379,733	
Long term debt	$ 25,042,011	$ –	
Shareholders' equity	$ 6,080,577	$ 24,375,809	
Weighted average number of Common Shares[1]	29,852,495	14,336,331	7,381,256

Note 1: At December 31, 1998, there were 43,065,736 Common Shares issued and outstanding. Subsequent to year end 21,134,203 Series 1 Preferred Shares and 17,580,000 Special Warrants were issued.

shareholder value

Operational Highlights

Proforma January 1, 1999[2]	Production	Reserves (proven and probable)
Western Canada		
Crude oil and NGLs:	2,500 bopd	7.3 mmbbls
Natural gas:	25 mmcf/d	91.1 bcf
Indonesia	3,425 bopd	36.9 mmbbls

Note 2: Amounts are proforma the purchase of oil and natural gas properties, completed in February 1999.

Subsequent to year-end, Equatorial completed a major step, initiated in November 1998, to balance it's exposure to risk in foreign properties by the acquisition of properties in western Canada.

These properties produce approximately 5,000 boe/d (25 mmcf/d gas and 2,500 bbls/d of oil and liquids), contain 11 mm boe of proven reserves and include more than 400,000 acres of undeveloped land.

Since the acquisition closed in February 1999, we have taken steps to realize the potential of our investment. We have seen successful results from a well in the Pica area of northwest Alberta and a horizontal re-entry well at the Kaybob South Triassic Unit in west central Alberta. Our 1999 capital expenditure program is mapped out to initially optimize existing opportunities and then progress to the exploration end of the spectrum by Q4 1999.

The Corporation was extremely fortunate to have Gulf Canada Resources Limited invest in the Corporation and entrust Equatorial Energy with a significant Western Canadian asset base. We look forward to working with Gulf to maximize value additions in this asset base.

In September 1998 we closed the Sembakung oil field acquisition for CDN $25mm in N.E. Kalimantan, Indonesia. The 3,000 bopd acquisition has 14mm barrels total proven and another 22mm barrels probable remaining sweet light oil reserves.

This field contains dramatic upside potential on the proven reserve base through working over existing wells, facilities and infill drilling. These activities will commence in Q3 1999.

From November 1996 to February 1999, Equatorial actively developed the Pilona technical assistance contract (TAC) in Indonesia jointly with Pertamina, the Indonesian state oil company. We were greeted by positive initial results in the workover and drilling campaign. Unfortunately the initial field productivity was not sustainable and high decline rates took their toll. We were unable to match the pre-war productive rates enjoyed by the Dutch. A write-down of $17mm was taken against the carrying value of the Pilona TAC in 1998, of which approximately 88 percent is attributable to management's revision of the Pilona TAC proven reserve volumes from 4.862 mm barrels to 554,000 barrels, and approximately 12 per cent attributable to low oil prices. The positive impact of this program has been the development of an excellent human resource base in Indonesia. We have a premier soft asset in our Indonesian executives and loyal staff in our Jakarta and field offices that, in concert with our partners at Pertamina, will take Indonesian productivity and cash flow to new heights, as we develop our properties in Sumatra and N.E. Kalimantan.

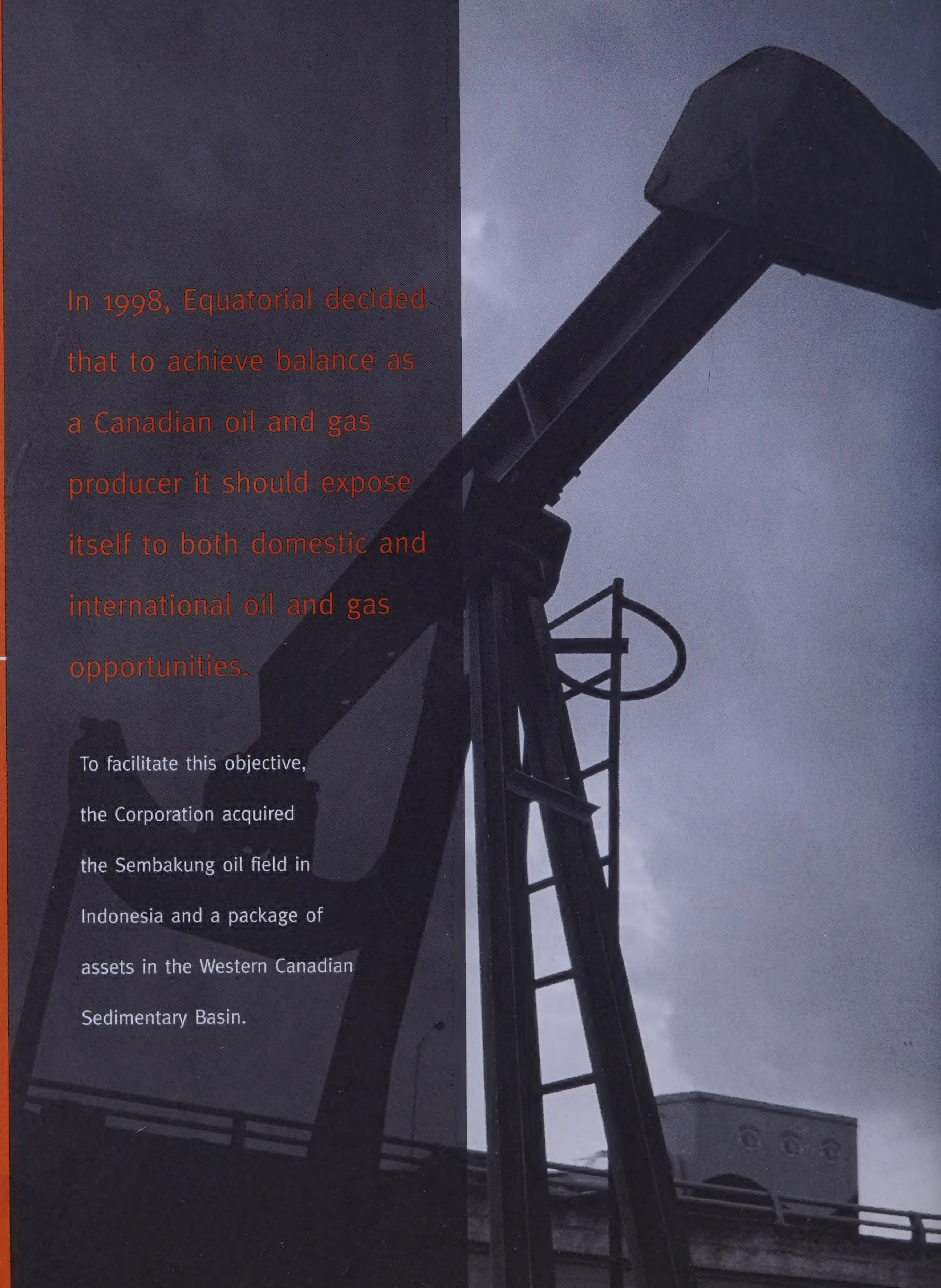
1998 will prove to be a catalytic year for the Corporation primarily due to our timely counter cyclical acquisitions. We have chosen to debt-lever the Corporation to take advantage of the low cost acquisitions in a low commodity price environment. Our debt is well-structured and the focus will be on increasing production and cash flow as quickly as reasonably possible. In conjunction with increasing commodity prices, our strategy will ultimately provide significant value addition to our shareholders.

This is an exciting time for Equatorial, but we could not have grown so quickly without the cooperation of a growing team of visionary individuals. Thanks are due to our shareholders, our Board of Directors, our employees and their families, for their selfless contributions to Equatorial's growth. I would like to thank my wife and family for their unwavering support through a year of extremes.

We look forward to your continued support as we move into a new millennium, and a new era of achievement in the Corporation's history.

On behalf of the Board of Directors,

G. Marshall Abbott
President and Chief Executive Officer



In 1998, Equatorial decided that to achieve balance as a Canadian oil and gas producer it should expose itself to both domestic and international oil and gas opportunities.

To facilitate this objective, the Corporation acquired the Sembakung oil field in Indonesia and a package of assets in the Western Canadian Sedimentary Basin.

During 1998, Equatorial set out to increase it's portfolio by acquiring assets with the potential to increase in production and reserves and to lead us into the millennium.

In light of these objectives, among the highlights of the year's operations were:

1. The purchase of 5,000 boe/d and 400,000 undeveloped net acres in western Canada;
2. The purchase of an 80 per cent working interest in the Sembakung oil field in northeast Kalimantan, Indonesia adding 36 million barrels of recoverable light oil to our reserves. Sembakung currently produces 3,000 barrels of oil per day; and
3. Drilling in the Tanjung Lontar oil field in South Sumatra, Indonesia resulted in eight oil wells.

Equatorial is now well positioned to capitalize on the potential of the recently acquired properties, to be realized from exploitation and exploration activities.

Strategy

In 1998, Equatorial decided that to achieve balance as a Canadian oil and gas producer it should expose itself to both domestic and international oil and gas opportunities. To facilitate this objective, the Corporation acquired the Sembakung oil field in Indonesia and a package of producing properties in the Western Sedimentary Basin in Canada.

These properties leave Equatorial poised to concentrate its efforts over the next few years on developing both its Indonesian and its Canadian assets. Through exploitation of these properties in the short term and further exploratory activities in the future, the new assets will set the base for the Corporation as it moves forward.

The following discussion describes the main areas that Equatorial will focus on in 1999.

CANADA

Core Areas

Equatorial has chosen four separate areas of activity on which to focus its operations in Canada:

- northwestern Alberta
- central Alberta
- southeastern Alberta
- southeastern Saskatchewan

These are areas that currently encompass high interest operated producing lands with existing infrastructure and extensive blocks of undeveloped land.

Concentration on the four areas will allow Equatorial to achieve solid returns while employing less capital for pipelines and facilities. Existing information will be used in the further development of the surrounding properties.

MAJOR AREAS IN WESTERN CANADA

Northwestern Alberta

Gordondale

Equatorial holds various interests with an average working interest of approximately 70 per cent in the Gordondale property, which comprises about 80 sections of land nearly 300 kilometres northwest of Edmonton, Alberta.

The area, which has been underdeveloped, has the potential for extensive exploration opportunities. Gas reserves have been identified in various company owned well bores that will be reviewed for exploitation capital expenditures through recompletions or tie-ins. The Gordondale area currently produces approximately 320 barrels of oil per day net to the Corporation.

Pica

The Pica property is located approximately 320 kilometres northwest of Edmonton, Alberta. Equatorial holds working interests ranging from 25 per cent to 100 per cent in approximately 20 sections of land in this area.

Recently, the 100 per cent working interest 15-36-83-6 W6M well was production tested at 10 million cubic feet per day of rich, sweet natural gas liquids from a five-metre interval within the Kiskatinaw formation. In addition, the well had previously tested 1.2 million cubic feet per day of sweet natural gas from the Bluesky formation.

There is an underutilized compression facility in the area that could be easily accessed to bring reserves on stream quickly.

Southeastern Alberta

Warwick

Equatorial holds a 100 per cent working interest in the majority of the lands in the Warwick property, which covers approximately 30 sections and is within 100 kilometres east of Edmonton, Alberta. The property currently produces over 1.6 million cubic feet of gas per day.

Warwick has seen little development over the past few years, and the area has the potential for exploitation and exploration activities. There is an intricate system of gathering lines and a compressor in the area that is currently underutilized. These facilities will make any new production immediately accessible to market at a low incremental capital and operating cost.

Grand Forks/Hays

Equatorial has interests ranging from 75 per cent to 100 per cent in this area in more than 50 sections of land, some 90 kilometres west of Medicine Hat, Alberta. Production is more than 500 barrels per day, achieved from various zones, including the Ellerslie, ARCS, Sawtooth and Lower Mannville. Various opportunities for production tie-in and recompletion have been identified, as well as opportunities to reduce operating costs and drill new exploration wells.

Central Alberta

Bigoray

The Bigoray property, located in Townships 50 and 52, Ranges 8 and 9 W5M, approximately 300 kilometres northwest of Calgary, covers approximately 6,870 gross hectares (3,589 net hectares). Equatorial is the operator for most of the Bigoray lands. Working interests vary from 25 per cent to 100 per cent, with the majority of the lands being 100 per cent owned.

Bigoray comprises 15 producing wells (11.5 net producing wells) with nine wells currently producing sweet gas that is rich in NGLs from the Glauconite and Ostracod horizons. The Bigoray gas is processed at the Chevron Bigoray plant, which is subject to deep cut processing, capable of ethanes plus extraction. Equatorial is reviewing the potential of re-entering and recompleting nine shut-in wells. As of January 1999, the Bigoray property was producing an average of seven million cubic feet of gas per day and 300 barrels of NGLs per day net to the Corporation.

Kaybob

Equatorial owns a 29.94 per cent working interest in the Kaybob South Triassic Unit No. 2, covering approximately 7,168 gross hectares (2,146 net hectares) in Township 62, Ranges 19 and 20 W5M, approximately 250 kilometres northwest of Edmonton, Alberta. This non-operated unit produces light, slightly sour oil (42 degree API gravity), gas and natural gas liquids. The unit, which commenced production in 1967, is currently under waterflood.

Kaybob South Triassic Unit No. 2 produces from 22 oil wells (6.6 net producing wells) with pressure support from 13 water injectors in a peripheral waterflood scheme. The injectors are located both along the western boundary of the unit and along the oil-gas interface to reduce gas cap migration into the oil leg. The reservoir is a stratigraphic trap in the Montney formation. Hydrocarbon entrapment is due to a facies change from a dolomite coquina into a tight siltstone in a northward direction.

In December 1998, a horizontal re-entry of an existing well was placed on production. Average gross unit production prior to the re-entry was 2,116 barrels of oil per day, and in February 1999, subsequent to the re-entry, the average gross unit production was 3,467 barrels of oil per day. As of March 15, 1999, the Kaybob South Triassic Unit No. 2 was producing 1,000 barrels of oil per day, 500 thousand cubic feet of gas per day, and 84 barrels of NGLs per day, totalling 1,134 barrels of oil equivalent per day net to Equatorial.

Southeastern Saskatchewan

Arcola

The Arcola property is a high interest operated area covering almost 10 sections in Townships 6 to 9, Ranges 1 to 3 W2M, approximately 200 kilometres southeast of Regina, Saskatchewan.

Canada

Equatorial recently acquired a significant base of undeveloped land in western Canada. This land will serve as the foundation for the Corporation's growth in years to come.

Currently, the undeveloped land base in Canada amounts to more than 400,000 net acres.

Oil is produced from the Frobisher-Alida and Tilston formations. Six wells were recently drilled in the Frobisher-Alida formation, and some wells have isolated legs that could be brought into production. Additional drilling in the field will also be considered to fully exploit the reserve base. Arcola produces approximately 140 barrels per day net to the Corporation.

Wauchope

The Wauchope property covers approximately 1,495 gross hectares (1,475 net hectares) in Townships 06 to 07, Ranges 32 to 34 W3M, approximately 130 kilometres southeast of Regina, Saskatchewan. Equatorial holds a 100 per cent working interest in 8 of the 10 wells. This pool is developed with 5 horizontal wells, and there are opportunities to increase production through various forms of remedial action in the horizontal well bores, including isolation of water production portions of a well, which was drilled too low in the formation.

In addition, further field development drilling can be considered in the future. There are also a number of undrilled sections within the property.

Wauchope produces over 300 barrels of oil per day net to the Corporation from 10 producing Alida wells.

Extensive Land Base

Equatorial recently acquired a significant base of undeveloped land in western Canada. This land will serve as the foundation for the Corporation's growth in years to come.

Currently, the undeveloped land base in Canada amounts to more than 400,000 net acres.

The undeveloped land base is located in four core areas of activity in western Canada. It represents blocks of land that are adjacent to producing properties in Equatorial's portfolio. The majority of the lands are very close to existing infrastructure, which will bring production from future wells on stream with greatly reduced facility construction costs.

In addition, a large percentage of these lands comprise high interest and operated leases that allow for maximum return on investment.

Undeveloped land base:	
Gross acres:	658,000
Net acres:	402,000
Average working interest:	61%

INDONESIA

Equatorial commenced operations in Indonesia in July 1997 and currently produces approximately 3,425 barrels of oil per day from two contract areas. The initial contract area is Tanjung Lontar in South Sumatra; the second contract area is Sembakung, on the northeast coast of Kalimantan.

Operations in Indonesia are conducted through production sharing arrangements called "Technical Assistance Contracts" or TACs, with Pertamina, the Indonesian state oil company. Under these TACs, Equatorial and its partners provide financing and technical expertise for development and production activities and earn an interest in hydrocarbons produced from the contract area. The oil and gas mineral rights are retained 100 per cent by Pertamina for Indonesia.

Sembakung

On September 28, 1998, Equatorial acquired 80 per cent of the Sembakung oil field in northeast Kalimantan. The field currently produces approximately 3,000 barrels of oil per day from 17 wells, all of which have been on production since the early 1980's. Equatorial's independent consulting engineers have assigned proven and probable recoverable oil reserves to Sembakung of 36 million barrels of oil; development of the remaining reserves will commence in July 1999.

Under the terms and conditions of Equatorial's joint venture agreement with its minority Indonesian corporate partner, Equatorial is entitled to 100 per cent of net operating profits until all capital expended by the Corporation to develop the property, together with existing operating loans due the Corporation, is recovered. Equatorial is also entitled to interest at prescribed rates on outstanding loans and advances.

Commencing in July 1999, Equatorial plans to extend the existing road system by one kilometre to access a drilling pad near SBK #10, the closest producing well to the first development location.

Approximate Indonesian Border

Indonesia

Equatorial commenced operations in Indonesia in July 1997 and currently produces approximately 3,425 barrels of oil per day from two contract areas.

The initial contract area is Tanjung Lontar in South Sumatra; the second contract area is Sembakung, on the northeast coast of Kalimantan.

The road extension is required because of the marshy conditions that prevail in most of the coastal region of Kalimantan. To minimize start-up expenditures, the Corporation will employ tracked vehicles to carry the drilling and completion equipment to the drilling pad rather than extend the road system beyond the initial kilometre. Actual drilling operations are scheduled to commence in the fourth quarter of 1999, with a target of three wells for the year. In addition Equatorial intends to conduct a 3-D seismic survey, the timing of which will be determined by this year's drilling results.

Given success in 1999, the year 2000's development program will consist of additional development drilling (approximately 12 wells), initial implementation of a reservoir pressure maintenance system, and construction of more permanent lease roads to access new drilling pad locations and enable routine, lower-cost workovers.

The Sembakung development program has the potential to increase Equatorial's Indonesian production by 300 per cent. The Corporation's capital program contemplates expenditures ranging from US$22 million to US$25 million over the next two years, approximately two-thirds of which will be internally generated by Sembakung operating cash flow.

Tanjung Lontar

The Tanjung Lontar TAC grants Equatorial the right to execute an oil field rehabilitation and exploitation program on the Tanjung Lontar, Sengkuang, and Arahan Banjarsari oil fields, located approximately 100 kilometres southwest of the city of Palembang in South Sumatra.

In early 1998, Equatorial drilled two wells to test several zones at mid-depths of approximately 4,500 feet at Tanjung Lontar. Nominal production of 50 to 100 barrels of stable oil per day was established from this program, resulting in the Corporation's approximately CDN$17 million write-down of its investment in Tanjung Lontar proven reserves through increased 1998 depletion expense.

However, the Corporation encountered success at Arahan-Banjarsari with the drilling of 12 shallow wells to depths of 800 ft. Although complex from a geological viewpoint, the risk of drilling shallow wells at Arahan-Banjarsari is more than offset by robust initial production rates from successful wells. To date, seven of the twelve wells have been established as producers with cumulative stable production estimates of approximately 300 barrels of oil per day.

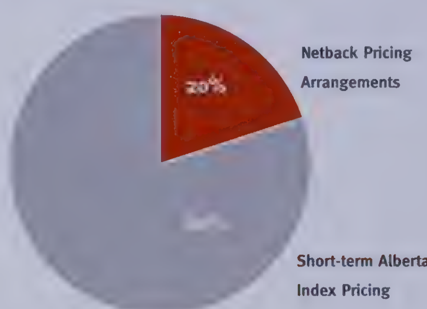
An additional five development wells are planned for mid-1999, together with the construction of a 40 kilometer pipeline to ensure low-cost and efficient delivery of crude oil from Tanjung Lontar during the October-February rainy seasons in South Sumatra.

Equatorial is also reviewing other Indonesian opportunities with Pertamina and will pursue these aggressively once planning for the Sembakung project is completed and the implementation phase is underway.

MARKETING

Natural Gas

Equatorial's natural gas portfolio is divided 20 per cent to aggregators under netback pricing arrangements and 80 per cent to marketers under short term Alberta index pricing. Since Equatorial does not currently have a large portion of its gas contracted under fixed pricing contracts it is strategically balanced to maximize revenue in a strong price environment.



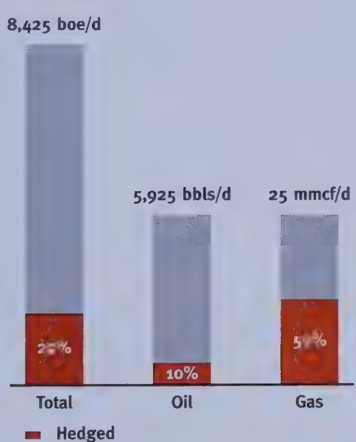
Oil and Liquids

In Canada, Equatorial sells its crude oil and liquids to markets under index priced contracts. The Corporation is relatively evenly weighted between light/medium and sweet/sour oil. The exposure to heavy oil is nil and the average crude oil gravity for the Canadian oil about 36 degrees API.

In Indonesia, Equatorial 's crude oil production averages 42 degrees API and is sold to Pertamina at a price of approximately $0.60 per barrel less than WTI oil prices.

Hedging

For 1999, Equatorial has sold forward 13 mmcf per day of natural gas production at $2.25/mmbtu at NYMEX and 500 barrels per day at US $14 per barrel.



Responsible Environmental Protection, Health and Safety Policies

Equatorial strives to be a "good corporate citizen" by taking all reasonable measures to ensure that the interests of our stakeholders are protected. As a participant in the oil and gas industry, our activities are regulated by various levels of government in Canada and Indonesia. While management is unable to predict changes in legislation, we do not expect that such changes will affect Equatorial in a manner materially different than other oil and gas companies of similar size.

Pro Forma Net Asset Value	Discount Rate	
January 1, 1999	**10%**	**15%**
Reserves (Proven Plus Probable)	206,535	166,501
Undeveloped Land ($50/acre)	20,268	20,268
Less Long Term Debt and Working Capital	73,056	73,056
Net Asset Value (Basic)	153,747	113,713
Basic Shares Outstanding	60,646	60,646
Net Asset Value/Basic Share	2.53	1.88
Fully Diluted Shares Outstanding	98,960	98,960
Fully Diluted Net Asset Value	174,965	134,931
Net Asset Value/Fully Diluted Share	1.77	1.36

Note: The net asset value is calculated proforma the Gulf Acquisition transaction which closed February 26, 1999.

Reserves (as of January 1, 1999 and before royalties)

	Oil and Liquids (mmbbls)			Natural Gas (bcf)		
	Proven	**Probable**	**Total**	**Proven**	**Probable**	**Total**
Canada	4,984	2, 362	7,346	60,610	30,549	91,159
Indonesia	14,061	22,850	36,911	–	–	–
TOTAL	**19,045**	**25,212**	**44,257**	**60,610**	**30,549**	**91,159**

Results from Operations

The following discussion of the Corporation's financial position should be read in conjunction with the Consolidated Financial Statements and related notes contained elsewhere in this Annual Report.

The Corporation's activities relate to oil and gas exploration and development. The Corporation follows the "full-cost" method of accounting for oil and gas operations whereby all exploration costs are capitalized until commencement of production. The costs are then amortized on the unit-of-production basis.

The Corporation began reflecting its operating results on November 30, 1995, with material results commencing on May 23, 1996. Administrative expenses comprise a large portion of activity in the Consolidated Statement of Operations since early 1996, with a breakdown as follows:

Year Ended December 31	1998	1997	1996
Salaries	$ 346,937	$ 209,192	$ –
Consulting fees	337,831	420,755	259,211
Travel	224,361	126,270	42,372
Shareholder communication	169,055	120,314	61,592
Legal, audit and tax	158,380	132,550	80,953
Office expense	93,504	98,106	38,952
Office rent	56,927	29,553	22,859
Public listing	36,219	48,125	10,410
Total	**$ 1,423,214**	**$ 1,184,865**	**$ 516,349**

Year Ended December 31, 1998 Compared with the Year Ended December 31, 1997

The Corporation incurred a loss of $24,364,969 or $0.82 per share for the year ended December 31, 1998, as compared to a loss of $1,053,371 or $0.07 per share for the comparative period in the prior year. Of 1998 expenses, 71% relate to the write-down of the Corporation's Indonesian, Australian and Trinidad properties, 9% to depletion and depreciation, 11% to operating costs on initial Indonesian oil deliveries, with the balance relating primarily to start-up administration expenses in the Corporation's Calgary head office.

Revenue and operating expenses all related to the Corporation's Indonesian oil and gas operations, which commenced in 1998.

The Corporation purchased EPS and its 80% owned subsidiary GEPS in late September 1998. Accordingly, oil sales from GEPS's producing Indonesian TAC from October 1, 1998 to December 31, 1998 were 261,456 Bbls (2,842 Bbls/d). Prices for this period averaged $17.40 (US$11.28) per Bbl.

The Corporation also holds a producing TAC through an indirect wholly owned subsidiary, Pilona. The Pilona TAC commenced deliveries of Indonesian oil to Pertamina on May 15, 1998. To December 31, 1998, the Pilona TAC sold 53,412 Bbls (232 Bbls/d) at prices that averaged $18.05 (US$11.94) per Bbl.

Operating expenses for 1998 exceeded revenues by $255,896, substantially all of the deficiency relates to operating losses incurred by the newly acquired GEPS TAC. The loss was attributable to a combination of low oil prices and fixed contractual GEPS operating arrangements entered into prior to the Corporation acquiring an interest in the TAC. An analysis of the write-down of petroleum and natural gas interests is as follows:

Indonesia	$ 17,000,000
Australia	1,781,084
Trinidad	315,310
	$ 19,096,394

Management has reviewed the December 31, 1998 carrying value of the Corporation's Indonesian full cost properties and has determined that a write-down of $17,000,000 is required, approximately 88% of which is attributable to a management revision of proved Pilona TAC reserve volumes from 4,862,200 Bbls to 554,000 Bbls, with the balance attributable to low year end crude oil prices. The ceiling test write down of the Indonesian full cost properties represents the $19 million net book value of the Pilona TAC reduced to $2 million, as

calculated in accordance with the full cost guideline of the CICA Handbook. The $2 million amount was calculated based on undiscounted future cash flows, based on year-end pricing, assigned by the Corporation to the Pilona TAC proved properties. The Corporation also subjected the costs related to the GEPS TAC to a ceiling test calculation which indicated that, based on December 31, 1998 oil prices, an additional ceiling test writedown of $19,000,000 would be necessary. Under the provision of the CICA guideline for full cost accounting in the oil and gas industry, the Corporation has chosen to not record this write-down because the costs relate principally to the acquisition of EPS, effective September 14, 1998 (within 24 months of year-end). The Corporation's management has an expectation of future oil prices higher than those experienced at December 31, 1998, and believes it can convert significant probable reserves assigned to the property to proved reserves within the 24 month period.

In 1998 management also performed a comprehensive review of its Australian geological and geophysical data and decided to terminate its joint venture activities in Australia. The Corporation retains nominal overriding interests, but the joint venture had discovered no significant hydrocarbons to date. Accordingly, the carrying value of the Australian properties has been reduced to $50,000 which represents the estimated net realizable value of the Corporations' Australian tax pools.

The Corporation participated in a joint study group to evaluate the potential for reactivation and redevelopment of old oil fields in Trinidad. The study was completed at a technical level and proposals were made to the Trinidadian government. After review of the opportunities available, the Corporation elected not to proceed further with the Trinidad project and wrote off the entire book value.

The 20% increase in the overall administrative expenses in the 1998 fiscal year , as compared to the amounts for the corresponding 1997 period, is attributable to a full year of Calgary head office expenses, as compared to ten months in the prior year. Seventy percent of the increase is attributable to increases in salaries and travel.

Forty eight percent of administrative expenses are attributable to salaries and consulting fees in 1998 as compared to 53% in the corresponding prior year period.

Salaries for 1998 include those of four full-time officers and one full time administrative assistant. An $18,691 executive placement fee was paid and also included in salaries in 1998. 1997 salaries include the salaries of the president, his administrative assistant and one full time officer. The Corporation established a Calgary office in March 1997 and commenced hiring full time salaried employees to reduce its reliance on consulting staff persons. Accordingly, consulting fees decreased by 20% in the fiscal year 1998 over the corresponding 1997 period.

Depreciation and depletion for 1998 was $2.5 million, as compared to $26,838 in 1997, as a result of approximately $2.4 million in depletion booked on Indonesian oil interests in 1998. Prior to 1998, Indonesian oil operations had not commenced, and no provision for depletion was required.

Travel costs of $224,361 in the 1998 fiscal year increased 77% from the corresponding period in 1997. Sixty percent, or $58,473 of the increase between corresponding periods, is attributable to Corporation directors' travel to a Jakarta, Indonesia board of directors' meeting, with the balance of the increase being travel associated with securing financing for the Corporations various projects. The balance of the costs in both years relate to travel activities associated with senior officers and directors directly pursuing oil and gas opportunities outside of North America to the extent that they cannot be capitalized to the Corporation's ongoing projects.

Substantially all of the increase in interest expense relates to a $26.5 million increase in long-term debt, of which $24 million was incurred on September 14, 1998 as part of the Corporation's acquisition of EPS.

Financial Resources and Liquidity

Working capital of the Corporation was $369,742 at December 31, 1998, as compared to $8.3 million at the previous year-end. To date, cash generated by the Corporation's financing activities has funded the Corporation's operations, capital expenditures and working capital requirements.

Effective September 14, 1998, the Corporation acquired 100% of the issued and outstanding common shares of EPS from FDM. EPS owns 80% of GEPS, which holds a TAC for the Sembakung oilfield in northeast Kalimantan, Indonesia.

Net assets acquired:	
Petroleum and natural gas interests	$ 33,952,928
Working capital	861,834
Asset held for resale (drilling rig)	918,720
Deferred income taxes	(6,504,407)
	$ 29,229,075

Consideration given:	
Long-term debt	$ 24,006,000
9,000,000 Common Shares of the Corporation	2,790,000
Amount to be paid in cash	639,853
Cash paid	891,347
Closing expenses	901,875
	$ 29,229,075

In 1998, the Corporation raised $3,712,550 by way of a private placement of 6,750,090 flow-through Common Shares at $0.55 per share. The flow-through Common Shares require the renunciation of resource expenditure deductions for Canadian income tax purposes to investors in accordance with Canadian income tax legislation. As at December 31, 1998, a total of $3,712,550 of Canadian Exploration Expense has been renounced to shareholders. The costs that are required to be incurred to support the renunciation will be incurred in 1999. Also in 1998, the Corporation raised $2,000,000 by way of the issuance of 2,000 Convertible Debentures which pay quarterly interest at 10% at the end of each calendar quarter and mature on November 21, 2003. Each Convertible Debenture is convertible into 2,800 Common Shares, 2,456 Common Shares or 2,188 Common Shares at any time before November 20, 2001, November 20, 2002 and November 20, 2003, respectively. The Corporation has a right to redeem the Convertible Debentures for Common Shares after November 20, 2000 if the Common Shares trade at a price per share in excess of $1.00 for 20 consecutive days. The Convertible Debentures are secured by a pledge of the shares of Pilona and an assignment of certain accounts receivable in Pilona. In connection with this financing, a commission of 2% was paid and Common Share Purchase Warrants to acquire 300,000 Common Shares for two years at $0.35 per share were issued to organizations controlled by two directors of the Corporation. 150,000 Common Share Purchase Warrants were exercised prior to December 31, 1998. Total financing costs for all equity and debt financings during the 1998 fiscal year were $485,313.

Comparative expenditures in petroleum and natural gas interests were as follows:

Year Ended December 31	**1998**	**1997**
Indonesia		
Capital development program	$ 5,332,850	$ 3,007,172
Pre-production costs	3,008,029	2,191,202
Ancillary acquisition costs - Pilona	347,458	172,569
	8,688,337	**5,370,943**
Exploration drilling - Australia	42,062	486,567
Onshore study - Trinidad	3,750	311,560
Acquisition costs - Other	26,456	–
Office equipment	112,271	71,892
	$ 8,872,876	**$ 6,240,962**

The Corporation's short-term and long-term cash needs will be met with cash flow from domestic properties acquired in the Gulf Acquisition and by continued reinvestment of cash flow from Equatorial's Indonesian properties.

The Gulf Acquisition significantly changed the financial position of Equatorial. In addition to providing Equatorial with domestic cash flow, it increased the undiscounted proved reserve base, at constant dollars, by $88 million, with approximately 72% of this total undiscounted value now in Western Canada. The Gulf Acquisition also initiated a relationship with a major international banking organization, which financed $45 million of the $72 million purchase price.

In Canada, the priority in 1999 will be to generate additional production on existing domestic properties. Equatorial will also be utilizing its $3.7 million in flow-through funds and operating cash flow to finance a $2.7 million exploration program and a $3.1 million development program which is expected to commence in the latter half of 1999. Equatorial also plans to reduce operating costs from their current levels through efficient management of its properties.

In accordance with the requirements of the Credit Facility, 500 Bbl/d of oil and 13 Mmcf/d of gas has been hedged for two years at a minimum price of US $14 per barrel and US $2.25 per mcf, respectively. Equatorial is reviewing the possibility of using additional hedging programs to secure future cash flow.

Equatorial intends to continue to fund its Indonesian operations from cash flow from its Indonesian properties and has also entered into discussions with various parties to provide additional financing to fund the capital expenditure program in Indonesia. If necessary, Equatorial will pursue the sale of concession interests to sustain financing of development activities. For both the Pilona TAC and the GEPS TAC, detailed planning is underway to reduce the capital and operating costs required for the timely exploitation of Indonesian reserves.

Year 2000 Issue

As a petroleum exploration and production entity with less than a three years operating history, the Corporation has had an opportunity to purchase computerized systems which are year 2000 compliant. Consequently, the Corporation's Canadian and Indonesian systems are either year 2000 compliant, or capable of timely remediation.

However, the Corporation is exposed to risk of failure of computerized systems of its key business associates, such as customers, suppliers, utilities, government agencies and other third parties. In the event that significant failure occurs in the activities of these business associates, it could have a material affect on the Corporation's operations and financial results. While the Corporation can develop contingency plans to cope with these concerns, there can be no assurance that the Corporation will not experience unanticipated negative consequences or material costs caused by undetected errors or defects in the technology used by third party business associates.

Senior management of the Corporation is currently developing contingency plans that will provide for appropriate responses to any operational interruptions that may be associated with year 2000 failures. The contingency plans will provide guidelines intended to reduce the impact to the Corporation and its personnel of any failure of third party systems due to year 2000 issues, and will be completed by the third quarter of 1999.

Canada

The Corporation recently purchased year 2000 compliant computer systems for its Calgary head office and field systems associated with operating the recent Gulf Acquisition remain largely manual. The Corporation will be communicating with its field suppliers and operators in the second and third quarter of 1999 to secure their commitment to uninterrupted field operations through the early year 2000 period.

Indonesia

The Corporation's risk in Indonesia is primarily with the systems of Pertamina, the Indonesian national oil and gas corporation, and secondarily with the systems of its Indonesian suppliers.

Under the terms of the Corporation's TAC's, the Corporation is responsible for the maintenance of the technical and financial system for all TAC activities. At the present time the Corporation has determined that these systems are year 2000 compliant.

The Corporation has a risk in Indonesia relating to the adequacy of the computerized Pertamina system for the timely payment of invoices. Management will work closely with Pertamina to develop a contingency plan by the third quarter of 1999 that will ensure continued timely payment for its oil in the year 2000. As in Canada, the Corporation will be communicating with its field suppliers and operators in the second and third quarter of 1999 to secure their commitment to uninterrupted field operations through the early year 2000 period.

To date the Corporation has expended nominal amounts on year 2000 contingency planning and expects to expend nominal amounts prior to December 31, 1999. The Corporation believes the above plan can be accomplished through dedication of management time and the use of external consultants, if required.

To the Shareholders of Equatorial Energy Inc.

The consolidated financial statements of Equatorial Energy Inc. were prepared by and are the responsibility of management. The statements have been prepared in conformity with the Canadian generally-accepted accounting principles appropriate in the circumstances and include some amounts that are based on management's best estimates and judgements.

The Corporation maintains systems of internal accounting controls designed to provide reasonable assurance that all transactions are properly recorded in the Corporation's books and records, that policies and procedures are adhered to , and that assets are protected from unauthorized use. The systems of internal accounting controls are complemented by the selection, training, and development of professional financial managers.

The consolidated financial statements have been audited by the independent accounting firm, Deloitte & Touche, whose appointment will be ratified yearly by the shareholders at the annual shareholders' meeting. The independent accountants conduct a review of internal accounting controls to the extent required by generally-accepted auditing standards and perform such tests and related procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The Audit Committee of the Board of Directors periodically meets with the independent accountants and management to satisfy itself that it is properly discharging its responsibilities. The independent accountants have unrestricted access to the Audit Committee, without management present, to discuss the results of their examination and the quality of financial reporting and internal accounting control.

G. Marshall Abbott
President & Chief Executive Officer
March 25, 1999

David N. Matheson
Executive Vice-President

To the Shareholders of Equatorial Energy Inc.

We have audited the consolidated balance sheets of Equatorial Energy Inc. as at December 31, 1998 and 1997 and the consolidated statements of operations and deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1998 and 1997 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Deloitte & Touche LLP

Chartered Accountants
Calgary, Alberta
March 25, 1999

Consolidated Balance Sheets

December 31	1998	1997
Assets		
Current		
Cash	$ 5,459,728	$ 9,124,645
Cash held in trust (Notes 3 and 9)	183,972	357,625
Accounts receivable	4,469,318	105,453
Asset held for resale	918,720	–
	11,031,738	9,587,723
Petroleum and Natural Gas Interests, full cost method (Note 5)	37,257,253	15,996,076
	$ 48,288,991	$ 25,583,799
Liabilities		
Current		
Accounts payable and accrued liabilities	$ 7,913,511	$ 1,207,990
Income taxes payable	1,215,185	–
Current portion of long-term debt (Note 6)	1,533,300	–
	10,661,996	1,207,990
Long-Term Debt (Note 6)	25,042,011	–
Deferred Income Taxes	6,504,407	–
Contingent Liability (Note 9)		
Shareholders' Equity		
Share capital (Note 7)		
Authorized		
Unlimited number of common shares without par value		
Unlimited number of preferred shares without par value		
Issued		
43,065,736 (1997 - 27,165,646) Common Shares	32,047,339	25,977,602
Deficit	(25,966,762)	(1,601,793)
	6,080,577	24,375,809
	$ 48,288,991	$ 25,583,799

See accompanying notes to the consolidated financial statements.

ON BEHALF OF THE BOARD

G. Marshall Abbott
Director

David N. Matheson
Director

Consolidated Statements of Operations and Deficit

Years Ended December 31	1998	1997
Revenue		
Gross oil revenue	$ 5,501,605	$ –
Government take	(2,910,464)	–
Net oil revenue	2,591,141	–
Expenses		
Write-down of petroleum and natural gas interests (Note 5)	19,096,394	–
Operating expenses	2,847,037	–
Depletion and depreciation	2,468,232	26,838
General and administrative expense	1,423,214	1,184,865
Interest and bank charges	845,965	8,671
Storage costs - asset held for resale	76,510	–
Interest revenue	(167,243)	(122,751)
Foreign exchange (gains) loss	366,001	(44,252)
	26,956,110	1,053,371
Loss Before Taxes	(24,364,969)	(1,053,371)
Income taxes (Note 10)	–	–
Net Loss	(24,364,969)	(1,053,371)
Deficit, Beginning of Year	(1,601,793)	(548,422)
Deficit, End of Year	(25,966,762)	(1,601,793)
Loss per share	$ (0.82)	$ (0.07)

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Changes in Financial Position

Years Ended December 31	1998	1997
Cash Provided By (Used In):		
Operating Activities		
Net loss for the period	$ (24,364,969)	$ (1,053,371)
Items not affecting cash:		
Write-down of petroleum and natural gas properties	19,096,395	–
Depreciation and depletion	2,468,232	26,838
Funds used in operations	(2,800,342)	(1,026,533)
Changes in non–cash working capital:	3,778,822	759,157
	978,480	(267,376)
Financing Activities		
Issue of debt on purchase of subsidiaries (Note 3)	24,575,311	–
Issue of securities on purchase of subsidiaries (Note 7)	2,790,000	2,292,556
Issue of common shares, for cash (net of issue expenses)	3,279,737	16,599,528
Issue of convertible debenture	2,000,000	–
Amount payable for purchase of subsidiary	639,853	–
Loan (repayments) proceeds	–	(685,300)
	33,284,901	18,206,784
Investing Activities		
Net assets acquired on purchase of subsidiaries (Notes 3 and 4)	(29,229,075)	(2,300,000)
Petroleum and natural gas interests	(8,872,876)	(6,240,962)
	(38,101,951)	(8,540,962)
(Decrease) Increase	(3,838,570)	9,398,446
Cash and Cash in Trust, Beginning of Year	9,482,270	83,824
Cash and Cash in Trust, End of Year	$ 5,643,700	$ 9,482,270

See accompanying notes to the consolidated financial statements.

1. Nature of Business

Equatorial Energy Inc. (the "Corporation" - formerly Australian Oilfields Pty Ltd.) is continued under the laws of Alberta, Canada. The Corporation is in the business of exploration for and development of petroleum and natural gas interests.

2. Significant Accounting Policies

a. Basis of presentation

The consolidated financial statements are presented in accordance with generally accepted accounting principles applicable in Canada and are expressed in Canadian dollars.

b. Basis of consolidation

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries Equatorial Energy (International) Inc. ("EQII"), Pilona Petro Tanjung Lontar Ltd. ("Pilona"), Energy Process Services Ltd. ("EPS") and Auckland Investments Pty. Ltd. The consolidated financial statements also include the accounts of its 80% owned subsidiary Genindo EPS Petroleum Ltd. ("GEPS"). All significant intercompany transactions and accounts have been eliminated.

c. Cash and cash equivalents

Cash includes short-term investments with a maturity of ninety days or less at the time of issue.

d. Petroleum and natural gas interests

The Corporation follows the full cost method of accounting for petroleum and natural gas interests whereby all costs of exploring and developing petroleum and natural gas reserves, net of government grants, are capitalized by individual country cost center. Such costs include land acquisition costs, geological and geophysical expenses, costs of drilling both productive and non-productive wells and overhead charges directly related to acquisition, exploration and development activities.

The total carrying value of the Corporation's petroleum and natural gas interests, less accumulated depletion, is limited to the estimated future net revenue from production of proven reserves, based on unescalated prices and costs plus the lower of cost and net realizable value of unproved properties, less estimated future development costs, general and administrative expenses, financing costs and income taxes. The carrying value of unproven properties is reviewed periodically to ascertain whether impairment has occurred. Where impairment has occurred, the costs are written down to their net realizable value.

For each cost centre, the costs associated with proven reserves are depleted on the unit-of-production method based on an independent engineering estimate of proved reserves, after royalties, with natural gas converted to its energy equivalent at a ratio of six thousand cubic feet of natural gas to one barrel of oil.

The Corporation provides for future estimated site restoration costs using the unit-of-production method based on costs and regulations in effect at the end of the year.

Office equipment is amortized on a straight-line basis over five years.

e. Government take

Operations conducted jointly with the Indonesian national oil company ("Pertamina") are reflected in these financial statements based on the Corporation's proportionate interest in such activities. All Pertamina interests, other than income and revenue taxes, will be considered to be government take. Government take on production from Indonesian properties represents the entitlement of Pertamina to a portion of the Corporation's share of crude oil, liquids and natural gas production and will be recorded using rates in effect under the terms of contracts at the time of production.

Under the terms of each contract, the Corporation is entitled to use gross proceeds of production to recover substantially all of the non-capital costs incurred during each year as well as current year depreciation for capital costs and any costs unrecovered from prior years. Such gross proceeds of production are included in revenue before government take.

The maximum cost recovery in any year is 80% of gross revenue for the first two years of production, and depending on the production sharing contract, 65% to 80% thereafter. Pertamina and the Corporation are entitled to share the remaining oil profits based upon the terms in each contract. The Corporation's pre-tax profit share on oil production is generally the rate that will provide an after-tax profit share of 15% prior to the domestic marketing obligations described below.

After a period of five years starting the month of the first delivery of crude oil produced from each new field in the contract area, the participant will typically have a domestic marketing obligation to sell a portion, not generally exceeding approximately 7% to 8%, of the crude oil produced from the contract area, at 15% of the market price at the point of export.

f. Foreign currency translation

Transactions of the Corporation and its subsidiaries that are denominated in foreign currencies are recorded in Canadian dollars at exchange rates in effect at the related transaction dates. Monetary assets and liabilities denominated in foreign currencies are adjusted to reflect exchange rates at the balance sheet date. Exchange gains and losses arising on the translation of monetary assets and liabilities, are included in the determination of income (loss) for the year with the exception of unrealized gains or losses on translation of long-term monetary liabilities, which are deferred and amortized over the remaining term of such liabilities on a straight-line basis.

g. Measurement uncertainty

Estimation of reserves in the Corporation's petroleum and natural gas interests is subject to inherent uncertainty. Since these reserve measures enter into the computation of net recoverable amount and depletion and amortization, there is uncertainty of measurement in the Corporation's petroleum and natural gas interests.

h. Estimates and assumptions

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

i. Fair value of financial instruments

The respective values of financial instruments approximated their fair values. These financial instruments include cash, cash held in trust, accounts receivable, accounts payable and accrued liabilities and long-term debt. Fair values were assumed to approximate carrying values for these financial instruments since they are short-term in nature and their carrying amounts approximate fair values or interest rates approximate current rates for like debt instruments.

j. Flow-Through Shares

Under the terms of the flow-through shares, the tax attributes of the related expenditures are renounced to Subscribers. To recognize the foregone tax benefits, the carrying value of petroleum and natural gas interests and share capital are reduced by the amount of the tax benefits renounced at the time that the related expenditures are made.

3. Acquisition of Energy Process Services Limited (EPS)

Effective September 14, 1998, the Corporation acquired 100% of the issued and outstanding common shares of Energy Process Services Limited from First Dynasty Mines Ltd. EPS owns 80% of Genindo EPS Petroleum Ltd. ("GEPS"), which holds a production sharing arrangement called a Technical Assistance Contract ("TAC") for a producing oilfield in East Kalimantan, Indonesia.

Net assets acquired, using the purchase method of accounting for the acquisition are as follows:

Petroleum and natural gas interests	$ 33,952,928
Working capital	861,834
Asset held for resale (drilling rig)	918,720
Deferred income taxes	(6,504,407)
	$ 29,229,075
Consideration given:	
Long-term debt	$ 24,006,000
9,000,000 common shares of the Corporation	2,790,000
Amount to be paid in cash	639,853
Cash paid	891,347
Closing expenses	901,875
	$ 29,229,075

Contingent consideration of US$3,000,000 is payable, during the life of the TAC, when the acquired petroleum property achieves the following average daily production targets for a 30 day period:

a. 7,500 barrels of oil per day - US$1,000,000 plus accrued interest
b. 10,000 barrels of oil per day - US$1,000,000 plus accrued interest
c. 12,000 barrels of oil per day - US$1,000,000 plus accrued interest

This consideration is secured by a promissory note due 30 days after each target is met. The additional cost represented by these notes will be recorded as petroleum and natural gas interests by the Corporation at that time. Interest at Chase Manhattan bank prime plus 3% accrues from September 14, 1998 to the due date.

At December 31, 1997, the Corporation had $357,625 (US$250,000) in trust as a deposit on this transaction.

Until September 14, 2001, the nine million common shares issued on the transaction are subject to a voting agreement in favor of either of two senior officers and directors of the Corporation. These shares cannot be transferred, sold or assigned by their owners until September 14, 1999, at which time all of the shares are released from these restrictions. The trust expires if both senior officers leave the Corporation, or if the Corporation's note holders elect to convert their notes under certain events of default (Note 6).

The holder of 5,516,130 of the nine million common shares issued on the transaction will have the right to appoint a nominee to the Corporation's board for as long as that shareholder has at least 10% of the Corporation's voting shares.

Under the terms of the shareholder agreement with GEPS, the Corporation will own a 100% revenue interest in the TAC. Once the Corporation pays the Indonesian government take, recovers its capital expenditures and collects any interest and principal on capital funds loaned to the 20% GEPS minority interest, its revenue interest reverts to 80%.

4. Acquisition of Pilona Petro Tanjung Lontar Ltd. (Pilona)

On November 22, 1996 the Corporation acquired 75% of Pilona by acquiring 100% of the issued and outstanding common shares of Antrim International Energy Inc. ("Antrim") and directly exercising a right held by Antrim to purchase 75% of Pilona. Pilona holds a TAC with the state oil and gas company of Indonesia. Total consideration for the transactions was $5,932,339 consisting of cash and shares of the Corporation.

On March 14, 1997, the Corporation completed the acquisition of the remaining 25% of Pilona. Consideration for this transaction was the issuance of 1,150,000 common shares of the Corporation at a price of $2.00 each. The net assets acquired comprised petroleum and natural gas interests which were recorded at $2,300,000.

At December 31, 1998, the remaining cash consideration of US$165,000 is due and is to be paid in installments of US$15,000 per month.

5. Petroleum and Natural Gas Interests and Segmented Information

	Indonesia (proven)	Australia (unproven)	Trinidad (unproven)	Other	Total
1998					
Petroleum and natural gas acquisitions					
Pilona TAC	$ 8,942,451	$ –	$ –	$ –	$ 8,942,451
GEPS TAC	33,952,928	–	–	–	33,952,928
Other	–	188,238	–	–	188,238
	42,895,379	188,238	–	–	43,083,617
Petroleum and natural gas exploration and development	13,539,254	1,642,846	315,310	26,457	15,523,867
Other equipment	–	–	–	219,796	219,796
	56,434,633	1,831,084	315,310	246,253	58,827,280
Accumulated depreciation, depletion and write-downs	(19,423,000)	(1,781,084)	(315,310)	(50,633)	(21,570,027)
Petroleum and natural gas interests	37,011,633	50,000	–	195,620	37,257,253
1997					
Petroleum and natural gas acquisitions					
Pilona TAC	8,594,993	–	–	–	8,594,993
Other	–	188,238	–	–	188,238
	8,594,993	188,238	–	–	8,783,231
Petroleum and natural gas exploration and development	5,198,374	1,600,786	311,561	12,500	7,123,221
Other equipment	–	–	–	107,525	107,525
	13,793,367	1,789,024	311,561	120,025	16,013,977
Accumulated depreciation, depletion and write-downs	–	–	–	(17,901)	(17,901)
Petroleum and natural gas interests	$ 13,793,367	$ 1,789,024	$ 311,561	$ 102,124	$ 15,996,076

During 1998, management reviewed its properties and made a provision of $19,096,394 to write down the carrying value of the Pilona production sharing contract in Indonesia under a ceiling test write down and the interests in Australia and Trinidad to estimated net realizable value. The Corporation also subjected the costs related to the GEPS TAC to a ceiling test calculation which indicated that, based on December 31, 1998 oil prices, an additional ceiling test write down of $19,000,000 would be necessary. Under the provision of the CICA guideline for full cost accounting in the oil and gas industry, the Corporation has chosen to not record this write down because the costs relate principally to the acquisition of EPS, effective September 14, 1998 (within 24 months of this year end). Management does not believe that the value of the EPS assets are permanently impaired.

As at December 31, 1998, unproved properties with capitalized costs of $16,976,464 were not subject to depletion.

Substantially all of the Corporations revenues, operating expenses, rig storage costs and depletion are attributable to Indonesia. All other expenses relate to activities in Canada.

6. Long-Term Debt

US$13,686,500 promissory notes, due on March 28, 2001. Simple interest accrues at 10% and is paid quarterly. The interest payments for the quarters ended December 14, 1998 and March 14, 1999 will be deferred and added to the principal.	$21,508,711
US$2,000,000 promissory note, with US$1,000,000 due September 14, 1999 and US$1,000,000 due September 14, 2000. Simple interest accrues at Chase Manhattan bank prime plus 3% and is paid at each calendar quarter end.	3,066,600
Debenture due on November 21, 2003. Simple interest accrues at 10% and is paid at each calendar quarter end. Each $1,000 debenture face value is convertible into 2,800 common shares, 2,456 common shares and 2,188 common shares of the Corporation before November 20, 2001, November 20, 2002 and November 20, 2003, respectively. The Corporation has a right to call for conversion into common shares after November 20, 2000, if the Corporation's common shares trade in excess of $1.00 for 20 consecutive days.	2,000,000
	26,575,311
Less: current portion	1,533,300
	$25,042,011

The notes are issued by the Corporation's wholly owned subsidiary EQII and are secured by a pledge of the shares of EPS and a security interest in the shares of EQII. On February 26, 1999, all note holders granted priority to the Corporation's bank for all assets other than the Corporation's existing rights and interests in Indonesia.

In the event the Corporation defaults on two consecutive interest payments or defaults on the payment of principal of the notes, the unpaid principal plus accrued interest can be immediately converted, at the option of the noteholder, into common shares based upon the market price prevailing at the time of default.

On February 26, 1999 the US$2,000,000 promissory note was paid in full, together with accrued interest.

The debenture is secured by a pledge of the shares of Pilona and an assignment of certain accounts receivable of Pilona. In connection with the financing, a commission of 2% was paid, and warrants to acquire 300,000 common shares for two years at $0.35 until November 20, 1999 and $0.4025 until December 20, 2000 per share were issued, to organizations controlled by two directors.

7. Share Capital

a. Issued

	Number of Shares	Capital Stock
Balance at December 31, 1996	14,265,646	$ 7,085,518
Issued for cash		
On exercise on Class "A" Special Warrants	3,250,000	5,037,500
On exercise on Class "C" Special Warrants	8,500,000	12,750,000
Class "B" Special Warrants issued on purchase of subsidiary subsequently converted to common shares (Note 4)	1,150,000	2,300,000
Common Share issue expenses	–	(1,195,416)
Balance at December 31, 1997	27,165,646	25,977,602

Issued for cash		
Flow- through common shares	6,750,090	3,712,550
Exercise of common share purchase warrants	150,000	52,500
Issued on purchase of subsidiary (Note 3)	9,000,000	2,790,000
Common share issue expenses	–	(485,313)
Balance at December 31, 1998	43,065,736	$ 32,047,339

The flow-through common shares involve the renunciation of resource expenditure deductions for income tax purposes to investors in accordance with Canadian income tax legislation. At December 31, 1998 a total of $3,712,550 of Canadian Exploration Expenses have been renounced to shareholders. The related expenditures will be incurred during 1999.

Three special warrant issues were closed during 1997 for total net proceeds of $18,892,084. These were comprised of 3,250,000 Class "A" Special Warrants issued for cash at $1.55 per warrant, 1,150,000 Class "B" Special Warrants issue for the purchase of the Corporation's remaining interest in Pilona (see Note 4) at $2.00 per warrant and 8,500,000 Class "C" Special Warrants issued for cash at $1.50 per warrant.

All special warrants were exercised prior to December 31, 1997 for no additional consideration resulting in the issuance of one common share per special warrant. Share purchase warrants issued on exercise of the Class "A" Special Warrants, expired unexercised on January 29, 1998.

b. Options and warrants outstanding at December 31, 1998:

	Number	Exercise Price ($)	Expiry
Outstanding at December 31, 1996	1,050,000		
Expired during the period	(1,050,000)		
Granted during the period:	1,485,000	1.55	June 3, 2002
	75,000	1.55	August 21, 2002
	65,000	1.55	September 30, 2002
	200,000(i)	1.95	February 10, 2000
	175,000	1.90	September 29, 2002
Outstanding at December 31, 1997	2,000,000		
Cancelled during the period	(175,000)	1.90	September 29, 2002
	(35,000)	1.55	August 21, 2002
Outstanding at December 31, 1998	1,790,000		

(i) This option was issued as partial consideration for the acquisition of 75% of Pilona.

Warrants			
Outstanding at December 31, 1998	150,000	0.35	until November 20, 1999
		0.4025	until November 20, 2000

Corporation directors, officers and service providers hold all options and warrants.

c. Loss per share

Loss per share has been calculated based on the following weighted average number of shares outstanding:

Year Ended December 31	1998	1997
Weighted average shares	29,852,495	14,336,331

8. Related Party Transactions

The Corporation acquired its interest in its Australian petroleum and natural gas prospect during 1997 from a company controlled by a common director for $215,000 which was $26,762 greater than original cost of $188,238. The property and shareholders deficit have been adjusted to reflect the transaction as if it had occurred at original cost.

During 1997, the Corporation paid $280,358 to a company controlled by a common director, as part of a joint venture entered into in the normal course of its business.

Amounts paid to related parties for consulting fees, rent, office expenses and share issue costs were as follows:

Year Ended December 31	1998	1997
Paid to directors	$358,000	$252,000
Paid to a company with a common director	–	46,788

Other than the acquisition of the Australian petroleum and natural gas property, the above transactions were entered into in the normal course of operations and were measured at a fair value exchange amount which approximates arm's length equivalent values.

9. Contingent Liability

On October 23, 1998 a statement of claim against the Corporation and Pilona was filed in the Court of Queen's Bench of Alberta. This claim in the amount of US$1,659,000 concerns a dispute over a Pilona trade payable for contract work performed in Indonesia in the ordinary course of Pilona's business. In management's opinion sufficient provision has been made for the claims that the outcome would not have a material impact on the Corporation's operations or financial position. At December 31, 1998, the Corporation also had $183,972 (US$120,000) in trust related to this claim.

10. Income Taxes

The potential income tax recovery differs from the amount which would be calculated based on the Indonesian tax rate of 44% which is applicable to essentially all of the Indonesian losses as follows:

Computed income tax benefit at the applicable Indonesian tax rate	$ 8,186,000
Less:	
Income tax impact of amounts which have no tax basis for Indonesian tax purposes	(3,320,000)
Potential future income tax benefit of amounts deductible for Indonesian tax purposes not recognized for accounting purposes	(4,866,000)
	$ –

Operating results of EPS from the effective date of acquisition, September 14, 1998 to December 31, 1998 have not resulted in any adjustment to deferred income taxes which were recorded by EPS prior to acquisition.

The benefit of the Corporation's Canadian losses for income tax purposes has not been recognized in the accounts. At December 31, 1998, the Corporation had losses for Canadian income tax purposes of approximately $2,842,000 of which $1,196,000 expire on December 31, 2005, $1,024,000 expire on December 31, 2004 and $622,000 expire on December 31, 2003.

11. Subsequent Events

a. Purchase transaction

On February 26, 1999, the Corporation purchased certain Western Canadian oil and gas properties for $72,000,000. Revenues and expenses for the properties will be recorded effective from January 1, 1999. Consideration given was as follows:

Cash of $50,000,000 net of accrued cash flow from October 1, 1998 to December 31, 1998	$ 45,076,007
Interest due on purchase price from October 1, 1998 to December 31, 1998	1,457,260
Convertible preferred shares (Note 11 c) ii))	12,000,000
Promissory note (Note 11 b) ii))	10,000,000
	$ 68,533,267

The entire amount of $68,533,267 will be allocated to the Corporation's petroleum and natural gas interests.

b. Debt financings

i) Conventional bank loan

On February 26, 1999, the Corporation obtained a 5-year revolving term bank credit facility in the amount of $45,000,000 to facilitate the purchase of the oil and gas properties as set out in Note 11(a). Interest on the loan accrues and is paid monthly at the Corporations choice of any of the following rates: Canadian prime plus 1%, U.S. Base rate plus 1%, LIBOR rate plus 2% or Bankers' Acceptance rate plus 2%. Principal repayments of

$12,000,000 are due in each of the first two years and $7,000,000 in each year thereafter. The loan is secured by a fixed and floating charge debenture and by a general security agreement.

In connection with the credit facility, the Corporation's existing U.S. note holders granted priority to the Corporation's bank for all assets other than the Corporation's existing rights and interests in Indonesia. In exchange for this, the Corporation modified the terms of its U.S. promissory note agreements as follows:

- the US$2,000,000 promissory note was repaid in full;
- the maturity date for its US$13,686,500 promissory note was advanced from September 14, 2001 to March 28, 2001;
- in the event of default on two consecutive interest payments or the payment of principal of the remaining notes, the unpaid principal plus accrued interest can be immediately converted, at the option of the noteholder, into common shares based on the market price prevailing at the time of default;
- the holder of a US$8,388,500 note would be able to maintain a member of the Board of Directors for as long as it also owns 10% or more of the issued and outstanding voting shares of the Corporation, or until the total principal balance of the US$13,686,500 notes is repaid; and
- an equity agreement which imposed a three year hold period was amended to remove the hold period for 9,000,000 common shares, issued as consideration for the purchase of EPS, to September 14, 1999.

ii) Promissory note

On February 26, 1999, a promissory note of $10,000,000 was issued to the vendor of the Western Canadian oil and gas properties which is due on the later of February 25, 2005 and one day following the repayment by the Corporation of all amounts owing under its existing bank agreements. Interest accrues and is paid quarterly at 7.2% per annum. The Corporation may pre-pay any or all of the outstanding principal and interest, but must, in certain circumstances, pay a pre-payment premium of 13.33% which would decline by 2.22% per calendar year until it becomes 1.11% in 2005 and expires thereafter. At the option of the vendor, the note and any accrued interest is convertible, in the event of certain events of default, into common shares at a price of $0.5678 per share.

c. Equity Financings

i) Issue of Special Warrants

Subsequent to December 31, 1998, and as a condition of obtaining the $45,000,000 conventional bank credit facility, the Corporation completed a private placement of 17,580,000 special warrants (the "Special Warrants") from treasury at $0.50 per Special Warrant for gross proceeds of $8,790,000.

Each Special Warrant is exercisable, at no additional cost, into one common share (the "Common Shares") and one-half of one warrant (the "Warrants") of the Corporation on the earlier of five days following the issuance of appropriate receipts by Canadian regulatory authorities for the Corporation's final Prospectus qualifying the distribution of the Common Shares and Warrants upon exercise of the Special Warrants, or one (1) year from the date of issue of the Special Warrants. Each whole warrant is exercisable into one Common Share, at $0.65 per share, for a period of three (3) years. If a receipt for a final prospectus is not obtained on or before May 27, 1999 from the Securities Commission in each of the Provinces of British Columbia, Alberta and Ontario, each holder of Special Warrants will be entitled to 1.1 Common Shares rather than 1 Common Share for each Special Warrant.

The Corporation's Agent for the private placement was paid an average cash commission of 5.0% of the gross proceeds and received compensation warrants which are exercisable, for no additional consideration, into one million Warrants.

ii) Issue of Convertible Preferred Shares

On February 26, 1999, the Corporation issued 21,134,203 preferred shares at $0.5678 for total consideration of $12,000,000 to the vendor of the Western Canadian oil and gas properties. The preferred shares bear dividends at 6.5% per year and are convertible, at the vendor's option, into a maximum of 21,134,203 Common Shares on or after February 25, 2000.

The Corporation can force conversion after February 25, 2001 if the weighted average trading price of the Corporation's common shares is at least $0.8517 for ten consecutive trading days.

Redemption by the Corporation is subject to an initial redemption premium of 12%. The redemption premium would decline by 2% per calendar year until it becomes 1% in 2005 and expires thereafter.

The preferred shares also entitle the vendor to appoint one director to the Board of Directors of the Corporation.

If the Corporation fails to either pay two consecutive dividend payments or comply with certain financial covenants, the vendor can convert all or a portion of the preferred shares into common shares, based upon the market price for the Corporation's common shares prevailing at the time of default. In the event of default, the vendor shall also be entitled, until such time as the preferred shares are converted into common shares, to elect two thirds of the Corporation's Board of Directors.

12. Commitment

The Corporation is committed under a lease of office premises to annual rental payments approximating $131,916 per annum for the next five years.

13. Uncertainty Due to the Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Corporation's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the Corporation, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

Board of Directors

G. Marshall Abbott [2]
President and Chief Executive Officer
Equatorial Energy Inc.

David N. Matheson [1]
Executive Vice-President
Equatorial Energy Inc.

Ir K.A. Sjaiful Achmad
President
Pilona Petro Tanjung Lontar Ltd.
President
PT Petro Inti Loka Nusantara

Nabih A. Faris [1]
President
Intergulf Group of Companies

Henry W. Sykes [1]
Senior Vice-President, Business Development, and General Counsel
Gulf Canada Resources Limited

Peter Meredith [2]
Chief Financial Officer
Diamond Works Ltd.

Robert R. Rooney [2]
Partner
Bennett Jones, Barristers and Solicitors

Notes:
1. Audit Committee
2. Compensation Committee

Officers

G. Marshall Abbott
President and Chief Executive Officer

David N. Matheson
Executive Vice-President

Larry M. Jones
Senior Vice-President and Chief Operating Officer

John R. Rooney
Senior Vice-President and Chief Financial Officer

Anthony Edwards
Vice-President, Exploration

Richard P. Cooper
Vice-President, Engineering

Solicitors

Bennett Jones
Calgary, Alberta

Banker

The Chase Manhattan Bank of Canada
Toronto, Ontario

Auditors

Deloitte & Touche LLP
Calgary, Alberta

Transfer Agent

Montreal Trust
Calgary, Alberta

Stock Exchange Listing

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Annual General Meeting

10:00 am June 24, 1999
The Metropolitan Centre
The Royal Room
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Calgary, Alberta

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